

## SUMMARY ANALYSIS OF AMENDED BILL

Author: Ortiz Analyst: Marion Mann DeJong Bill Number: AB 1633

Related Bills: AB 1631, SB 1425, Telephone: (916) 845-6979 Amended Date: 03/17/98

SB 1478

Attorney: Doug Bramhall

Sponsor:

**SUBJECT:** Shift Burden of Proof/Financial Disability/Innocent Spouse/FTB Report on Electronic Filing

- ☒ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced January 5, 1998.
- ☐ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
- ☐ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.
- ☐ FURTHER AMENDMENTS NECESSARY.
- ☐ DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.
- ☐ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED \_\_\_\_\_ STILL APPLIES.
- ☐ OTHER - See comments below.

### SUMMARY OF BILL

This bill would incorporate into state law some of the federal Taxpayer Bill of Rights 3 provisions proposed by Congress. Specifically, this bill would:

1. Under certain circumstances, shift the burden of proof from taxpayers to the department in court proceedings (Section 18404). See Burden of Proof on page 2.
2. Expand the "innocent spouse" relief provisions by allowing proportioned relief (Section 18533). The Innocent Spouse discussion in the analysis of the bill as introduced January 5, 1998, still applies.
3. Declare the intent of the Legislature that, by year 2007, 80% of all personal income tax returns should be filed electronically. In addition, require the department to include in its annual report to the Legislature both the department's progress of achieving the goal and legislative changes necessary to assist in meeting the goal (Section 18621.5). The Electronic Filing discussion in the analysis of the bill as introduced January 5, 1998, still applies.
4. Suspend the statute of limitations for refund claims for a period where the taxpayer is suffering from physical or mental impairment that is expected to

### DEPARTMENTS THAT MAY BE AFFECTED:

\_\_\_ STATE MANDATE

\_\_\_ GOVERNOR'S APPOINTMENT

#### Board Position:

☐ S ☐ O  
☐ SA ☐ OUA  
☐ N ☐ NP  
☐ NA ☐ NAR  
☒ X PENDING

#### Agency Secretary Position:

☐ S ☐ O  
☐ SA ☐ OUA  
☐ N ☐ NP  
☐ NA ☐ NAR  
DEFER TO \_\_\_\_\_

#### GOVERNOR'S OFFICE USE

Position Approved \_\_\_\_\_  
Position Disapproved \_\_\_\_\_  
Position Noted \_\_\_\_\_

Department/Legislative Director Date  
G. Alan Hunter 3/30/98

Agency Secretary Date

By: Date:

result in death or to last for a continuous period of at least one year (Section 19310). The SOL/Financially Disabled Taxpayers discussion in the analysis of the bill as introduced January 5, 1998, still applies

#### SUMMARY OF AMENDMENT

The March 17, 1998, amendments substantially changed the burden of proof provisions, made technical changes recommended by the department and revised Section 3 of the bill to reflect changes to Section 18621.5 enacted by AB 1040 (Stats. 1997, Ch. 605). Specifically, the amendments would shift the burden of proof to the department under certain circumstances only with respect to Personal Income Tax Law (PITL) taxpayers who have exhausted all administrative remedies.

Except for the Burden of Proof discussion and technical considerations, the department's analysis of the bill as introduced January 5, 1998, still applies. The Burden of Proof discussion is replaced with the following.

### **1. Burden of Proof**

#### EFFECTIVE DATE

This provision would apply to any court proceeding as of January 1, 1999.

#### SPECIFIC FINDINGS

**Under current federal law**, taxpayers may be required to keep certain records and may be requested by the IRS to substantiate items reflected on their federal income tax returns. The IRS may issue a deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return or third party information returns (W-2s, 1099s, etc.). If collection is determined by IRS to be in jeopardy, a jeopardy assessment is issued, whereby the amount of the deficiency is immediately due and payable.

Taxpayers may protest deficiency assessments or jeopardy assessments to the IRS. In the event the IRS denies the protest, under the federal appeals system, the taxpayer may either: (1) appeal the assessment to the Tax Court (which has a small claims division for amounts of \$10,000 or less), or (2) pay the assessment and file a claim for refund with the IRS. Once the IRS denies the claim, the taxpayer may file suit for refund in a U.S. District Court or the U.S. Court of Claims.

In these reviews, a rebuttable presumption exists that the IRS's determination of tax liability is correct. Taxpayers have the burden of proving that the IRS's action was incorrect and establishing the merits of their claims by a preponderance of the evidence. This review is an independent judicial review by a trial court upon evidence submitted by the parties. Both the taxpayer and the IRS can bring actions in appellate courts to appeal final adverse determinations, except small claims division determinations, which are binding.

**Under current state law**, all taxpayers may be requested by the FTB to furnish substantiation of the items reflected on their income tax returns and certain taxpayers (i.e., water's-edge taxpayers) may be required to keep certain records. The FTB may issue a proposed deficiency assessment based on: taxpayers' inability

to substantiate items reflected on their income tax return, third-party information returns (W-2s, 1099s, etc.), or information FTB receives from IRS. In the rare instance that collection is determined by FTB to be in jeopardy, a jeopardy assessment is issued whereby the amount of the deficiency is immediately due and payable.

If the taxpayer disputes an assessment, the taxpayer may (1) protest the proposed deficiency assessment or jeopardy assessment by filing a written "protest" with the FTB, or (2) pay the assessment and file a claim for refund (in which case the taxpayer may proceed to the Board of Equalization [BOE] or Superior Court if the claim is denied or no action is taken on the claim within six months).

The taxpayer's administrative forum for appealing an adverse FTB action is the BOE. The BOE is the first independent administrative level of review of an FTB action. During the appeal process, the BOE makes an independent determination of the action. The BOE accepts evidence submitted by the taxpayer and, if requested by the taxpayer, grants an oral hearing on the matter. In the independent review by BOE, there is a rebuttable presumption that the FTB action was correct. Hence, taxpayers have the burden of producing evidence to show that the FTB's action was incorrect and establishing the merits of their position by a preponderance of the evidence.

In the event of a final adverse BOE decision the taxpayer's recourse is to pay the amount due and bring an action for refund against the state in Superior Court. With residency matters payment is not required. In litigation, as with appeals, there is a rebuttable presumption that the FTB action was correct. In addition, a taxpayer in a suit for refund is the plaintiff. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of proving that the FTB's action was incorrect and establishing the merits of their claims by a preponderance of the evidence.

**This provision** would shift the burden of proof from a PITL taxpayer to the FTB for litigation cases provided the taxpayer has (1) exhausted all administrative remedies, (2) asserts a reasonable dispute, and (3) fully cooperates with FTB with respect to the issue in dispute. This provision would not be construed to override any requirement under the PITL to substantiate any item.

#### Policy Considerations

This provision would raise the following policy considerations.

- Shifting the burden of proof in any court proceeding could impact every assessment made by the department and could result in reduced compliance and more intrusive audits.

The Tax Executives Institute, representing approximately 5,000 corporate tax professionals, indicated in a letter to the Congressional Ways and Means Committee Chair that its organization fears that shifting the burden of proof would result in a much more intrusive IRS.

Because wage earners' and retired individuals' records are supplied to the IRS and FTB by employers and others, shifting the burden of proof to taxing agencies in these instances would be somewhat insignificant. However, businesses dealing primarily with cash transactions, those in

the "underground economy," could benefit from a shift in the burden of proof. Such taxpayers may be more likely to take aggressive positions on returns and contest audit results. Audits would have to be more thorough to obtain the proof necessary to sustain audit findings.

- On the other hand, for many taxpayers the income tax system is their only contact with government and the large bureaucracy frightens them. Thus, they may not protest or appeal audit findings even if they believe them incorrect. Proponents believe that this provision would create a better balance between government and taxpayers.
- Generally in civil cases the burden of proof is on the plaintiff, the party seeking corrective action. The taxpayer is the plaintiff in all California Superior Court actions. In addition, for tax cases the taxpayer has control of the records and documents necessary to ascertain the taxpayer's tax liability.
- Federal legislation regarding the burden of proof has not been enacted. Generally, state legislation is enacted after federal legislation to allow the state to conform (where applicable) to new federal law. The burden of proof provisions in this bill are different that what is being proposed by Congress, the proposed federal legislation (1) limits the burden of proof shift to the smaller taxpayers, (2) defines what is considered "taxpayer cooperation," and (3) limits the provision to court proceedings arising in connection with "examinations" commencing after the date of enactment.
- Currently, the taxpayer is asked to substantiate the amounts reported on the return, and deductions are considered to be a matter of legislative grace. The Internal Revenue Code and Revenue and Taxation Code have few statutes that specifically require substantiation; the requirement to substantiate an item rests mainly in case law regarding burden of proof.

#### Implementation Considerations

This provision would raise the following implementation considerations. Department staff is available to help the author resolve these concerns.

- The terms "administrative remedies," "reasonable dispute" and "cooperates fully" are not defined. If the intent is to pattern California law after the federal provision, it may be better to conform by referencing the federal provision so that federal regulations (which should be provided by the IRS to clarify these terms) are effective for California purposes.
- One significant department workload is assessments based upon federal Revenue Agent Reports (changes made by the IRS to gross income or deductions reported on the federal return). Currently, such adjustments are presumed to be correct and generally are not protested at the state level. It is unclear whether this provision would remove that presumption and require the department to prove that the changes made by the IRS to the federal return are correct for any cases that are litigated.

- Currently, FTB generally retains taxpayer records for a period of three to four years and then destroys them, as authorized under R&TC Section 19530. Shifting the burden of proof to the department may require longer retention of records and increased costs for storage.
- The potential of a shift in the burden of proof would require FTB to engage in more extensive evidentiary gathering activities. This may require personnel additions to the audit and legal staff.
- Under certain conditions, this bill would shift the burden of proof to FTB in ascertaining the "income tax liability" of a taxpayer. It is unclear whether the burden of proof would be shifted to the FTB on issues related to penalty and interest. This ambiguity derives from the fact that current law is unclear as to whether penalty and interest are an addition to, and therefore, part of the tax, or something separate and apart from the tax.
- It is unclear whether this provision would apply to all court proceedings as of January 1, 1999. If the burden of proof is shifted in current cases where the department has assumed that a rebuttable presumption of correctness exists, the department may not have prepared the case to meet a shift in the burden of proof. The provision should be effective for assessment which are proposed after January 1, 1999, in order to give the department sufficient time to prepare the factual issues in the case.

#### FISCAL IMPACT

##### Departmental Costs

The departmental costs associated with this provision are unknown. The costs could increase, however, to the extent that additional supporting evidence would be required on all cases to support the state's position on any potential litigation cases.

##### Tax Revenue Estimate

This provision would result in unknown revenue losses.

##### Tax Revenue Discussion

The revenue loss for this bill would be determined by those assessments that may be revised due to incomplete documentation to support the assessment and revenues lost from possible negative effects on voluntary compliance.

Revenue losses in any given year are unknown. It is not possible to determine the number of cases in which the outcome would be changed because of the shift in the burden of proof. It is not clear how the courts would define "fully cooperate."

The Joint Committee on Taxation in its revenue estimate of H.R. 2676 estimated that shifting the burden of proof would result in a cumulative revenue loss of \$795 million for fiscal years 1998 to 2002. It has been expressed at the federal level that a negative revenue impact from reduced self-assessed reporting may result, which could have an effect on

departmental audit programs. Because the language of this bill does not conform to the federal proposed legislation, it is not possible to use the federal revenue impact to measure the impact from this bill.